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FTB NOTICE 2011-03

Subject: Abusive Tax Shelters – California Listed Transactions – Circular Cash Flow

PURPOSE

This Notice constitutes a published position of the Franchise Tax Board within the meaning of subparagraph (A) of paragraph (4) of subdivision (a) of section 18407 of the California Revenue and Taxation Code (R&TC).

The Franchise Tax Board has become aware of transactions involving parent corporations ("Parent") that artificially increase their basis in the stock of their subsidiaries ("Subsidiary"), without any outlay of cash or property, prior to the Parent selling the stock of Subsidiary to an unrelated third party. This Notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, and substantially similar transactions, as "listed transactions" for purposes of subparagraph (A) of paragraph (4) of subdivision (a) of R&TC section 18407. This Notice also alerts parties involved with these transactions to certain responsibilities that may arise from their involvement with these transactions.

FACTS

The transactions described in this Notice involve a Parent that is planning to sell its wholly-owned Subsidiary. One way to minimize gain on the sale is to increase Parent's stock basis in Subsidiary. Parent contributes a promissory note or other instrument to Subsidiary in a transaction intended to qualify as a contribution to capital under Internal Revenue Code (IRC) section 351, which is applicable for California purposes pursuant to R&TC section 24451. Subsidiary then takes steps to generate what the taxpayer argues are earnings and profits in order for any distributions to Parent to be treated as a dividend and deductible or excludable from the Parent's income pursuant to the appropriate section of the R&TC. One method of creating what the taxpayer argues are earnings and profits involves Subsidiary's formation of a new, second-tier subsidiary and the accompanying sale of Parent's promissory note (now an intangible asset of Subsidiary) to the newly-formed subsidiary in exchange for a new promissory note. Because the basis of the intangible asset in Subsidiary's hands is zero, Subsidiary claims earnings and profits for the full value of the intangible asset.

Shortly before or after Subsidiary has purportedly generated earnings and profits, Parent pays off the promissory note issued to Subsidiary either in one lump sum payment or in partial amounts. Within a close proximity of time after Parent's payment to Subsidiary, Subsidiary distributes the cash back to Parent. Because Subsidiary purports to have

earnings and profits (which may have been artificially created), Parent claims that the distribution from Subsidiary is a dividend and deductible or excludable from net income pursuant to IRC section 351, which is applicable for California purposes pursuant to R&TC section 24451, and since it is a dividend, Parent further claims that it does not have to reduce its basis in Subsidiary pursuant to R&TC section 24451, which conforms to IRC section 301(c)(2). The end result is that Parent claims an increased basis in Subsidiary for its contribution of the promissory note, but the contribution of the promissory note never remained with Subsidiary. Parent does not receive additional consideration from the sale of Subsidiary, although it has purportedly increased Subsidiary's value from its contribution of the promissory note.

DISCUSSION

The transactions described in this Notice are designed for the purpose of, or utilized in a manner that exploits and abuses California's nonconformity to a substantial portion of the federal consolidated return regulations provided under IRC section 1502. Specifically, with respect to earnings and profits and stock basis, California has no provisions similar to the investment adjustments allowed for federal purposes under Treas. Reg. Sections 1.1502-32 and -33. The earnings and profits of each entity in the combined report are calculated on a separate accounting basis and do not reflect the earnings of any lower tier subsidiaries. (See *Appeal of Young's Market Company*, Cal. St. Bd. of Equal., Nov. 19, 1986.) Likewise, the cost basis of a unitary subsidiary's stock is not adjusted to reflect the earnings of that subsidiary. (See *Appeal of Safeway Stores*, Cal. St. Bd. of Equal., Mar. 2, 1962; see also *Appeal of Rapid American Corp.* Cal. St. Bd. of Equal., Oct. 10, 1996.) The end result of the exploitation and abuse is that the Parent artificially inflates its basis in its stock in Subsidiary without any actual out-of-pocket cost to Parent.

The Franchise Tax Board intends to challenge the purported tax benefits from these transactions based on the application of various theories, including judicial doctrines such as substance over form, sham transaction, and step transaction doctrines. Pursuant to the authority in Revenue Ruling 78-397 (1978-2 C.B. 150) and *Andantech L.L.C. v. Commissioner* (TC Memo 2002-97), the Franchise Tax Board may argue that the circular transactions, including the circular cash flows, should be wholly disregarded for tax purposes. Under appropriate facts and circumstances, the Franchise Tax Board also may argue that the transactions lack economic substance and/or lack valid non-tax business purposes. The Franchise Tax Board also may argue that the transactions violate the anti-abuse rule under R&TC section 24431, subdivision (a) (substantially similar to IRC section 269(a)(1)), and/or that the contribution to capital did not meet the requirements under R&TC section 24451, which conforms to IRC section 351, because it was illusory and remained in Subsidiary for a temporary period of time.

Note that the manner in which Subsidiary generates its alleged earnings and profits is not determinative of whether this Notice applies to a particular transaction. Use of a different method of creating earnings and profits than that described herein will not prevent a transaction from being deemed substantially similar to the transactions described in this Notice. Additionally, the Franchise Tax Board does not concede that earnings and profits are actually being created in any permutation of these arrangements.

Persons participating in transactions substantially similar to these transactions are deemed to be participating in these transactions for purposes of R&TC section 18407.

Persons participating in these transactions have reporting requirements under R&TC section 18407. Persons failing to comply with the reporting requirements are subject to penalties under R&TC section 19772. Persons that participated in these transactions may be subject to penalties, including, but not limited to, accuracy-related (R&TC section 19164, subdivision (a)), noneconomic substance transaction (R&TC section 19774), and 100% interest-based (R&TC section 19777). In certain circumstances, persons that participated in such transactions may also be subject to the fraud penalty (R&TC section 19164, subdivision (c)).

Material advisors, as defined in IRC section 6111(b), have reporting and list maintenance requirements under R&TC sections 18628 and 18648. Material advisors failing to properly comply with these requirements are subject to penalties for failure to maintain and/or furnish investor information (R&TC section 19173) and failure to disclose reportable transactions (R&TC section 19182). Material advisors may also be subject to a penalty for promoting an abusive tax shelter under R&TC section 19177.

DRAFTING INFORMATION

The principal author of this notice is Roman Johnston of the Franchise Tax Board, Legal Division. For further information regarding this notice, contact Mr. Johnston at the Franchise Tax Board, Legal Division, P. O. Box 1720, Rancho Cordova, CA 95741-1720.